

A quarterly newsletter examining recent tax developments for the business professional.

DEFERRAL OF CANCELLATION OF INDEBTEDNESS INCOME ALLOWED BY RECOVERY AND REINVESTMENT ACT

The recently enacted American Recovery and Reinvestment Act of 2009 (commonly referred to as the "Recovery Act") significantly amended some of the rules governing the recognition of cancellation of indebtedness ("COD") income in response to the current economic crisis. In brief, newly adopted Section 108(i) permits certain taxpayers recognizing COD income in 2009 and 2010 to elect to defer the recognition of that income until 2014 and beyond. The new Section 108(i) election is discussed in detail below.

One of the basic tenets of federal income taxation is that gross income includes income from the discharge of indebtedness. See Internal Revenue Code ("IRC") § 61(a)(12). The recognition of COD income can result from a wide variety of transactions, such as the conveyance of property in satisfaction of a debt, the cancellation or modification of a debt instrument, the acquisition of debt by a related party, and the contribution of debt to capital. Although IRC § 108 provides various circumstances in which COD income can be excluded from a taxpayer's gross income (for instance, exclusions apply if the debt is discharged in a Title 11 bankruptcy case or while the taxpayer is insolvent), if one of the IRC § 108 exclusions does not apply, taxpayers are required to recognize the COD income in the year the debt is discharged.

In order to reduce the economic hardship associated with the recognition of COD income, the Recovery Act amended IRC § 108 in order to allow taxpayers to elect to defer the recognition of certain COD income, that would otherwise be recognized in 2009 and 2010, until 2014. Pursuant to IRC § 108(i)(1), eligible taxpayers can elect to include COD income resulting from the "reacquisition" of an "applicable debt instrument" during the 2009 and 2010 taxable years *ratably* over the five-tax-year period beginning in the 2014 taxable year.

For purposes of IRC § 108(i)(1), an "applicable debt instrument" means any debt instrument issued by a C corporation or any other person in connection with the conduct of such person's trade or business. Likewise, the term "debt instrument" is broadly defined to include any bond,

debenture, note, certificate, or other instrument or contractual arrangement constituting indebtedness under IRC § 1275(a)(1). Finally, the term "reacquisition" also is broadly defined to include any acquisition of an applicable debt instrument by the debtor or a person related to the debtor, including (i) an acquisition of the debt instrument for cash; (ii) the exchange of the debt instrument for another debt instrument; (iii) the issuance of corporate stock or a partnership interest in exchange for the debt instrument; (iv) the contribution of a debt instrument to capital; and (v) the complete forgiveness of the debt instrument by the holder.

The election to defer the recognition of COD income under IRC § 108(i)(1) must be made on the taxpayer's tax return for the year of the discharge. Although the election can be made on an instrument-by-instrument basis, once made, the election is irrevocable.

The mechanics of IRC § 108(i)(1) are best illustrated by the following example:

Example: Assume that, in 2009, Taxpayer reacquires notes that it previously issued for an adjusted issue price of \$10 million for \$6 million, which acquisition triggers the recognition of \$4 million of COD income. Also assume that Taxpayer elects to defer the COD income over a five-year period under IRC § 108(i)(1). In this case, the Taxpayer will recognize \$800,000 of COD income in each of the 2014 through 2018 taxable years (\$4 million/5 years) by virtue of making the IRC § 108(i)(1) election.

RECENT HIGHLIGHTS & HOT TOPICS

Recent Highlights & Hot Topics provides a brief summary of the latest breaking tax developments and happenings on a taxpayer-by-taxpayer basis.

INDIVIDUAL INCOME TAX: The IRS has issued temporary regulations explaining how to allocate prepaid qualified mortgage insurance premiums to determine the amount that is deductible under IRC § 163(h)(F). The temporary regulations provide that an individual taxpayer may allocate prepaid mortgage insurance premiums over the shorter of the (1) stated term of the mortgage; or (2) a period of 84 months. Treasury Regulation (“Treas. Reg.”) § 1.163-11T. Instructions for calculating the deductible portion of any prepaid mortgage insurance premiums is available in IRS Publication 936, Home Mortgage Interest Deduction.

CORPORATE TAX: The IRS recently eased its ruling stance for issues arising in corporate divisions. Previously, the IRS would not issue letter rulings in this area. However, in Revenue Procedure 2009-25, the IRS announced that taxpayers can now request rulings on the tax consequences or characterization of a transaction (or part of transaction) that occurs in the context of an IRC § 355 distribution of stock.

CRIMINAL TAX: The IRS recently posted details on its settlement offer for those that voluntarily and timely disclose unreported offshore income. The objective of the settlement offer is to bring taxpayers who have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws. Those meeting the terms of the offer will avoid criminal prosecution and some substantial penalties, including the fraud penalty and the foreign information return penalties. However, disclosing taxpayers still have to pay back taxes and interest for six years, pay either an accuracy or delinquency penalty on all six years, and pay a penalty of 20% of the amount in the foreign

bank accounts in the year with the highest aggregate account or asset value.

INTELLECTUAL PROPERTY TAX: Favorable tax law changes originally made in 2006 continue to offer significant tax planning opportunities for songwriters and music publishers. Songwriters can elect to treat self-created musical compositions and copyrights in self-created musical works as capital assets, subjecting the sale of such assets to long-term capital gain rates of 15%, in lieu of the personal income tax rates presently ranging as high as 35%. Music publishers also can realize tax savings by electing to amortize musical works over a five year period, rather than the period during which the song was projected to generate income.

REAL ESTATE TAX: Taxpayers who make a charitable contribution of a conservation easement may be eligible for an increased tax deduction. In order to qualify, the taxpayer must contribute a real property interest to a qualified organization exclusively for certain conservation purposes. Permissible conservation purposes include the preservation of land for outdoor recreation for the general public, the protection of natural wildlife habitats, the preservation of open space, or the preservation of an historically important land area or certified historic structure. Through 2009, the 30% contribution base limit on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals are permitted to deduct the fair market value of any qualified conservation contribution to the extent of the excess of 50% of the contribution base over the amount of all other contributions. The excess can be carried forward up to 15 years.

Please be advised that this newsletter only provides brief descriptions of tax information of general interest and that any tax information contained herein was not intended and cannot be used for the purpose of: (1) avoiding penalties that may be imposed by the Internal Revenue Service; or (2) supporting, promoting, or marketing any transaction(s) or matter(s) addressed herein.

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